ADB

QUARTERLY ECONOMIC UPDATE

NEPAL

JULY 2005

Asian Development Bank

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Acronyms and abbreviations

ADB	Asian Development Bank
CaR	cost at risk
CPI	consumer price index
CRR	cash reserve ratio
CSD	Central Security Depository
GDP	gross domestic product
IMF	International Monetary Fund
LMF	liquidity monitoring framework
LTO	large tax payers office
MFA	Multi-Fiber Agreement
NEPSE	Nepal Stock Exchange
NRB	Nepal Rastra Bank
VAT	value added tax
WTO	World Trade Organization

MACROECONOMIC REVIEW

A. Overview

1. Real GDP growth slowed to 2.0% in FY2005[1] – less than half the government's initial projections – due to a slowdown in the agriculture sector, a sharp downturn in the tourism sector, and continued weak performance of the industrial sector. While the erratic monsoon in 2004 dampened agricultural performance, frequent conflict related disruptions suppressed activity in the tourism and industry sectors.

2. A tight fiscal stance was maintained in FY2005. This was due to continued low capital spending, which more than offset the slight shortfall in targeted revenue collections. Low spending in the productive sectors of the economy will have an adverse impact on the medium term growth prospects of the country and urgent efforts are required to reverse the trend[2].

3. Commercial bank liquidity slightly tightened during the first nine months of FY2005, reflecting sluggish growth of deposits and an increase in consumer loans. Inflationary pressures picked up following the upward adjustments in petroleum prices and Value Added Tax (VAT) rate, low agriculture output, import controls on sugar in late 2004, and the increase in civil servant allowances. Faced with the challenging task of both keeping the inflation under control and spurring economic growth, Nepal Rastra Bank (NRB) announced a cautious monetary policy for FY2006.

4. The conflict and the expiration of the Multi-fiber Arrangement (MFA) in December 2004 adversely affected the external sector. Readymade garment exports fell precipitously causing overall exports growth to halve; imports declined; tourism receipts fell sharply; and growth of remittances slowed. The current account surplus widened to 4.4% of GDP in the first nine months of FY2005 compared with 3.3% of GDP during the same period in FY2004. The balance of payments remained stable with foreign exchange reserves equivalent to eight months of import cover.

B. Output

5. The modest economic recovery achieved since FY2003 -3.0% in FY2003 and 3.2% in FY2004 from -0.4% in FY2002 – achived since FY2003 lost momentum during FY2005. According to the initial estimates of the Central Bureau of Statistics, real GDP grew 2.0% in FY2005 – much lower than the government's initial forecast of 4.5%. The estimate is also lower than the ADB projection of 3.0% in December 2004, which was based on the assumption that economic disruptions would not increase further. However, insurgency related disruptions such as *bandhs* and blockades escalated during the remainder of the fiscal year, adversely affecting the industry and service sectors. Also, the impact of the poor monsoon in 2004 on agriculture is estimated to have been more significant than expected earlier.

6. Agriculture grew 2.8% in FY2005 compared with 3.9% in FY2003 - contributing 1.1 percentage points of GDP growth (Figure 1.1). Paddy, which comprises almost 20% of the agricultural GDP, declined 3.7% due to poor monsoon and a decline in the cultivated area of paddy – the latter a response to the sharp decline in paddy prices after the bumper crop in FY2004. There was risk of a contraction in agriculture output after the poor monsoon, but weather conditions were favorable in winter. Production of winter crops such as wheat, maize, sugarcane, jute, and products such as tea and milk increased significantly[3] and offset the decline in paddy output.

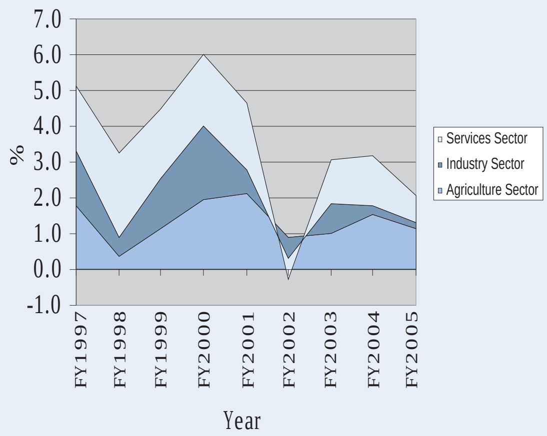
7. Growth in industry eased to 0.7% in FY2005 from 1.0% in FY2004. A sharp rise in the price of construction materials and

[1] FY2005 refers to mid-July 2004 to mid-July 2005. All data for FY2005 in the Quarterly Economic Update are initial estimates.

[2] For the impact of the conflict on the economic growth, refer Ra, S. and Singh, B. 2005. Measuring the Economic Costs of Conflict: the Effect of Declining Development Expenditures On Economic Growth, Asian Development Bank, NRM Working Paper Series, No. 2, June 2005.

[3] Production of wheat, maize, sugarcane, jute, tea and milk is expected to increase 3.9%, 7.9%, 3.1%, 4.6%, 7.3% and 3.4% in FY2005, respectively.

Figure 1.1- Sources of Growth, FY1997-FY2005



Source: Central Bureau of Statistics

continued sluggishness in public construction caused the construction sector to contract 2.4% during FY2005 and contributed to the slowdown in the industrial sector. Growth in the manufacturing sector, which accounts for about 40% of the industrial GDP, improved to 2.8% in FY2005 from 1.7% in FY2004 – but was still much lower than the average growth of 9.6% in the decade before FY2001. The low growth reflects the impact of conflict related disruptions such as frequent *bandhs*, forced closure of businesses, and restrictions on the movement of people and goods.

8. Service sector grew 2.1% in FY2005 compared with 4.0% in FY2004 and contributed 0.8 percentage points of GDP growth. The slowdown in the service sector was caused entirely by a sharp 3.0% decline in the trade and tourism sub-sector. While tourism was adversely affected by the negative publicity generated by the conflict, disruptions such as frequent strikes and blockades caused trade related activities to decline. However, transport, communications and storage, and finance and real estate sub-sectors remained buoyant and grew 5.4% and 2.9%, respectively. The transport sector benefited from the expansion in air travel and purchase of new vehicles, the communication sector from a significant expansion of mobile telephone services in the first half of the year, and the finance sector from the expansion of urban financial services, especially consumer loans.

9. On the demand side, both public and private investment continued to be sluggish in FY2004, reflecting the weak investment climate in the country. The investment rate (gross domestic investment as % of GDP) fell 1.1 percentage points to 26.1% in FY2005. As in FY2004, economic growth in FY2005 was, thus, largely led by remittance-driven consumption, which contributed almost 1.8 percentage points to GDP growth in FY2005.

10. Nepal's economic growth has slowed from an average of 4.9% in the FY1991-FY2001 period to 2.0% during the FY2002-FY2005 period – a period that experienced escalation of the conflict. However, the 2.9 percentage point growth loss observed in the conflict period is much lower than the loss seen in other conflict – affected countries[4]. This can be attributed to two main factors. First, manufacturing – the sector most sensitive to conflicts – contributes less than 10% to Nepal's overall GDP. Although the conflict has reduced manufacturing growth – growth was -0.6% in the 2002-04 period compared with 9.6% in the FY1991-FY2001 period – the overall impact on the economy has been small. Second, Nepal has benefited from a steady inflow of remittances from overseas economies, which has buoyed consumption and ameliorated the adverse effects of the conflict.

11. Beginning in the early 1990's, Nepal embarked on a wide array of reforms to liberalize the import regime, investment and licensing regulations, entry of firms, and the financial sector, and improve fiscal and financial management. As a result, Nepal accelerated its trend growth to about 5% in the 1990's. This was also accompanied by a slight deceleration in population growth. The pace of per capita GDP growth, therefore, accelerated in the 1990's. The share of trade in GDP and world trade almost doubled. By contrast, the share of agriculture in of GDP dropped from about 70% to 40%. But after the conflict intensified in 2001, Nepal's economic growth has been much slower than the rate achieved in the 1990's and the rate currently being achieved by other South Asian countries.

[4] According to research carried out by Nicholas Staines of IMF, real GDP growth was 12.3 percentage points below normal for conflict-affected countries in the 1990's.

12. Nepal needs to restart and accelerate growth to create employment for its burgeoning population. Nepal's current level of investment is insufficient to support the growth targets of the government. Achieving the Tenth Plan growth targets will require a rebound in private and public investment, and a major improvement in factor productivity. In the absence of foreign investment, domestic investors need to learn to adapt to the security situation, and if they can obtain sufficient access to domestic and foreign savings—facilitated by a stronger banking system—they could generate the investment levels needed to realize higher growth. The government could facilitate this process by strengthening the legal, regulatory, and institutional framework for private sector activity, accelerating the pace of ongoing governance and public enterprise reforms, increasing investment in human capital, and improving infrastructure.

C. Policy Developments

13. Important policy reform measures have been introduced in recent months. As a part of the ongoing financial sector reforms, the government has established criteria for determining willful defaulters of commercial bank loans and NRB has issued new directives to banks and financial institutions not to extend credit to blacklisted borrowers. A high level Economic and Financial Sector Reforms Committee has been formed to monitor the ongoing financial sector reforms and to accelerate the pace of other reforms, including public enterprise and labor reforms.

14. The long-pending Nepal Water Supply Corporation, Water Supply Management Board, and Drinking Water Tariff Fixation Commission ordinances were promulgated in April 2005. These ordinances will help ensure a professional and commercially driven operational environment and facilitate efficient operations and management in the water supply sector. The government is also actively pursuing reforms to establish an electricity regulatory body and unbundling of the Nepal Electricity Authority. A draft labor policy, which aims to improve flexibility of labor markets, is also being formulated.

15. Notwithstanding these initiatives, the overall pace of reforms has slowed. There has only been limited progress in privatizing or closing down loss making public enterprises, which are a major drain on the government budget. While privatization actions have been taken on 24 of 60 public enterprises so far, the process remains incomplete, with liabilities of many still not addressed. Performance contracts have been initiated in five enterprises, but little progress has been achieved in introducing professional management in the public enterprises to improve the performance and accountability. The dependence of public enterprises on the budget for meeting their operating losses, investment needs and debt servicing liabilities has not improved.

16. In civil service reform, important achievements have been made in right sizing the civil service, adopting a merit based recruitment and promotion system, developing a personal information system, and enacting a new civil service ordinance. However, enhancing the motivation and service orientation of the civil service remains a challenge, particularly in an environment where the functioning of the bureaucracy has been constrained by the conflict. Further reforms are required to insulate the civil service from political interference.

17. Urgent efforts are needed to meet the challenges arising from the expiration of the MFA and Nepal's accession to the World Trade Organization (WTO). However, owing to the uncertain political environment, only limited progress has been achieved in implementing necessary reforms. Nepal will find it difficult to increase exports in the increasingly liberal global trading regime unless it pursues reforms to enhance productivity and competitiveness.

18. The FY2006 Budget signals a commitment to accelerate the reforms in all of the government's priority areas. The privatization of public enterprises is to continue, the labor law is to be amended to facilitate entry and exit, action is to be taken against willful defaulters of bank loans, WTO commitments are to be met, private sector capacity is to be improved, infrastructure is to be built to develop Nepal as a transit point between China and India, and the public service delivery manual is to be implemented. The budget

pronouncements are a welcome development but the real challenge for the government will be to implement these measures in a time bound manner.

19. Speedy implementation of the government's reform agenda continues to be important not only for improving governance and the investment climate in Nepal but also to resolve the conflict and restore peace. Greater urgency and initiative are required to tackle the challenges facing Nepal in the backdrop of a continuing conflict.

D. Fiscal Performance

20. A tight fiscal stance was maintained in FY2005. The overall budget deficit was contained at 1.1% of GDP compared with 1.0% of GDP in FY2004 due to the significant under spending of the capital budget and improved revenue collection. A stronger revenue effort enabled the government to realize public savings of 1.2% of GDP in FY2005 from 0.9% of GDP in FY2004. The government has found it difficult to shift fiscal policy towards providing support for a fragile economy. For three years in a row, fiscal policy has not been adequately stimulative. The government should consider a more vigorous use of fiscal policy to support medium term growth prospects of the country, without at the same time substantially weakening the government's long-term fiscal position.

21. Government receipts grew 13.3% year on year to NRs81.3 billion in FY2005 (Table 1.1). This was mainly due to a robust growth in revenue collection, which increased 15.8% to NRs70 billion or about 13.2% of GDP. Revenue was buoyed by improved collections of VAT and income tax and a significant collection of dividends from state owned enterprises. VAT collection increased sharply by 30.8%, reflecting the hike in the VAT rate from 10% to 13% during the mid-term review of the FY2005 Budget. The

Table 1.1: Fiscal Performance
(NRs Million)

	Actual		Budget		Budget Target Achivement (%)		% change
Item	FY2004	FY2005	FY2004	FY2005	FY2004	FY2005	FY2005
Revenues and Grants	71,764	81,305	75,046	87,271	95.6	93.2	13.3
Current Revenues	60,028	69,499	59,534	71,076	100.8	97.8	15.8
Tax Revenue	48,255	54,604	48,307	56,056	99.9	97.4	13.2
Nontax Revenue	11,772	14,895	11,227	15,020	104.9	99.2	26.5
Capital Revenues	453	636	643	844	70.4	75.3	40.4
Grants	11,283	11,170	15,512	15,351	72.7	72.8	-1.0
Expenditures and Net Lending	76,797	87,095	90,721	100,786	84.7	86.4	13.4
Re-current Expenditures	55,552	63,117	63,478	70,098	87.5	90.0	13.6
Capital Expenditures	17,759	20,161	22,576	27,683	78.7	72.8	13.5
Lending Less Repayments	3,486	3,817	4,666	3,005	74.7	127.0	9.5
Overall Balance (incl. Grants)	-5,033	-5,790	-15,675	-13,515	32.1	42.8	15.0
Financing of the Overall Balance	5,033	5,790	-15,675	13,515	-32	43	15
Foreign Financing	1,863	2,954	6,675	9,984	28	30	59
Domestic Financing	3,170	2,836	8,356	3,531	38	80	-11

Source: Ministry of Finance and Nepal Rastra Bank share of VAT collections in the total revenue effort increased from 24% to 27%, surpassing custom taxes as the single largest contributor to the government's revenue effort for the first time.

22. Dividend receipts increased 95% over FY2004 due to a significant NRs3.9 billion transfer of profits from the Nepal Telecommunication Limited. More than 40% of the revenue gain of the government in FY2005 was on account of this measure. The FY2005 revenue performance will be difficult to sustain in FY2006, since a similar transfer may not be possible. Further hikes in tax rate could be considered but they may not substantially increase Nepal's revenue to GDP ratio without administrative strengthening and significant widening of the tax base (Box 1.1).

22. On the expenditure side, there was a 14% under-spending of the government's revised budget target. Capital spending, in particular, fell 21% short of the revised budget target due to conflict-related constraints on carrying out development activities and a sharp decline in foreign loans. The capital budget target of NRs30.7 billion was ambitious to begin with but political and conflict related disruptions during the year pushed it out of reach. Nevertheless, government spending in FY2005 was still 13.4% higher year on year due to the low base of government spending in FY2004. The improvement in government spending is attributable to the increase in civil servant allowances, increased security spending, improved prioritization of government expenditures, and the higher cost of government projects in the conflict environment. The social sectors saw the greatest increase in spending; security spending also continued to increase rapidly.

23. Total debt service in FY2005 is estimated at NRs19.8 billion or about 22% of total government expenditures – more than double the share in FY1991. Security expenditure stood at NRs17.4 billion or about 21% of total government expenditure – two and half times the share in FY1991. Security expenditure and debt service together accounted for 43% of total government expenditure and over half of total revenue. This reveals the heavy fiscal burden imposed by debt service and security expenditure and the insufficient resources left for investment in infrastructure and human resource development. The burgeoning debt service expenditure is of particular concern in the context of the sharp fall in foreign loan receipts of the government in recent years.

24. Continued conflict could make it difficult for the government to increase revenues significantly in a sluggish or weakening economy; while current expenditures are likely to increase in order to accommodate higher security and debt service costs, as well as increased recurrent expenditure commitments associated with recent initiatives in education, health, among others. Thus, the revenue surplus, if any, will be further reduced. The resulting squeeze on cash management will be difficult to manage; and funding for many activities will have to be curtailed. In such a situation, funding constraints could limit development activities far below what is possible even within the current absorptive capacity and implementation constraints.

25. Nepal, thus, needs to take early actions to address impending short-term budget management problems, as well as to improve efficiency/effectiveness of public spending over the near to medium term. Looking beyond the immediate problem of managing the FY2006 Budget, efforts will be needed to improve resource mobilization, limit spending within the levels of resource availability and to improve the effectiveness of public spending.

E. FY2006 Budget

26. The FY2006 Budget, presented on 16 July 2005, is expansionary to support economic growth. The macroeconomic framework for the budget assumes a GDP growth of 4.5%. Inflation is projected at around 5%, in line with price developments in India, given the exchange rate peg with the Indian rupee(IR). The budget deficit in FY2006 is forecast at 2.2% of GDP or about 1.1% above the deficit in FY2005.

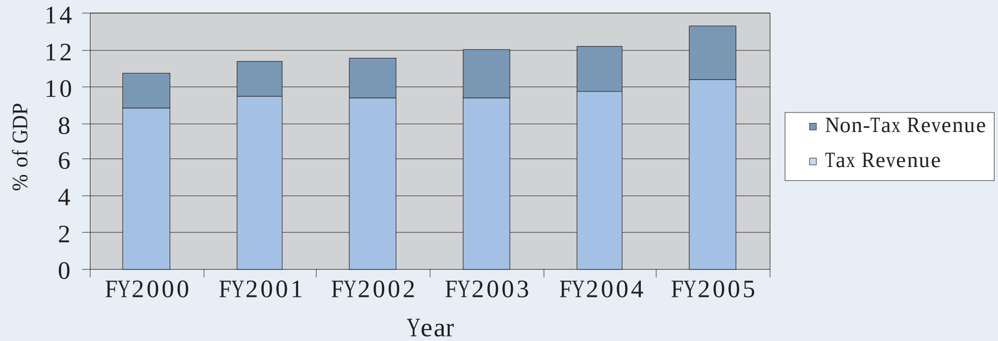
27. The budget proposes a total expenditure outlay of NRs111.5 billion (19.3% of GDP), or about 2.8% increase over FY2005. Of this, recurrent spending has been increased by 1.2% of GDP, while capital spending is budgeted to

Box 1.1 - Strengthening Revenue Mobilization

The need for more efforts to strengthen revenue mobilization cannot be overemphasized. Nepal's revenue surplus has remained low not only because of the recent sharp increase in recurrent expenditures, but also because of its weak revenue performance. To increase the revenue surplus, a stronger tax effort is required.

Nepal has implemented important tax reforms over the past decade. For example, a Value Added Tax (VAT) was adopted in 1997, tariffs on imports have been rationalized and progressively reduced over time, and important reforms in income taxes (through a New Income Tax Act of 2002) have been introduced. These have helped to improve the tax/GDP ratio over the last five years (Figure 1.11), and have also helped to reduce the heavy dependence on trade taxes. Nevertheless, the tax base is still narrow and tax administration remains extremely weak.

Figure 1.11 - Government Revenue, FY2000-FY2005

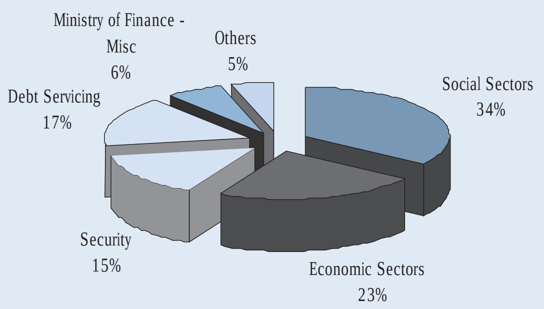


Source: Ministry of Finance

While the revenue performance must be improved, this will be a challenging task for several reasons: (i) the ongoing conflict (and political instability) has been adversely affecting economic growth, in turn undermining the scope for revenue gains; (ii) some of the fast growing sources of income (such as remittances from abroad and small scale commercial agriculture) are presently outside the reach of the tax system; and it is not easy to bring them into the tax net without undermining incentives and encouraging leakages (particularly of remittances) into unofficial channels; (iii) Nepal's import tariffs are already low by South Asian standards, limiting the potential for revenue gains from such taxes; and (iv) some of the central government taxes (such as land and property taxes) have already been transferred to local bodies; and more such transfers could be expected in the future.

Notwithstanding these constraints, more can be done to improve revenue collections in the short to medium term. To this end, some of the possible measures are: (i) widening the tax base by increasing the coverage of the VAT and rationalizing VAT and customs exemptions; (ii) strengthening tax administration, specifically by making the newly established Large Tax Payers Office (LTO) fully operational, strengthening it with adequate staff, training and providing performance based incentives; (iii) implementing the three-year Customs Modernization Plan which, among others, seeks to improve and regularly update the import valuation system, strengthen customs administration and improve its supervision, monitoring and incentive systems; and (iv) increasing tax rates, particularly VAT and excise.

Figure 1.2 - FY2006 Budget Allocations



Source: Ministry of Finance

increase by 1.6% of GDP. As per the recommendations of the Pay Commission, the 20% allowance provided to civil servants during FY2005 has been converted to a salary increase. Revenue is assumed to grow by 14% to about 13.8% of GDP in FY2006, up from 13.2% of GDP in FY2005. It will be challenging to achieve the revenue target, as a large transfer of profits from state owned enterprises will likely not be possible in FY2006. However, the revenue target could be attained if revenue administration is strengthened. The budget has also incorporated a sharp 171% increase in foreign financing and a 62% increase in domestic financing over the expected outturn in FY2005. The realization of the projected foreign financing will depend on the acceleration of the reforms measures proposed in the budget and improvement in implementation of development projects.

28. One of the highlights of the FY2006 Budget is the significant increase in allocation for social sectors, mainly as result of the sector wide approach adopted by the government in education and health sectors (Figure 1.2). The total allocation for social services – education, health, drinking water, and local development – has increased to 7.6% of GDP in FY2006 compared with the revised estimate of 5.9% of GDP in FY2005. Within this, the total education budget has increased to NRs21 billion or 0.6% of GDP above the revised estimate for FY2005. Similarly, the allocation

Table 1.2: Monetary Survey
(NRs Million)

Item	July 2003	April 2004	July 2004	April 2005	% Change in First Nine Months FY2004	FY2005
Assets						
Net Foreign Assets	91407	102542.4	108800.6	112846.6	15.1	7.8
Net Domestic Credit	228444	240128.2	251089	270523.8	5.6	5.1
Claims on Government (net)	62825	55384.5	62313.7	59750.9	-11.8	-4.1
Claims on Government Enterprises	14662	16112	15974.7	15409.4	9.9	-3.5
Financial Enterprises	11829	13190.4	13343.9	12373.5	11.5	-7.3
Nonfinancial Enterprises	2833	2921.6	2630.8	3035.9	3.1	15.4
Claims on Private Sector	150957	168631.6	172517.4	195363.5	11.7	13.2
Liabilities	–	–	–	–	–	–
Broad Money Supply (M2)	245911	268265.7	277122.6	294399.8	9.1	6.2

Source: Nepal Rastra Bank

for economic services – agriculture, roads, electricity and irrigation – has increased to 4.9% of GDP in FY2006 compared with the revised estimate of 4.2% in FY2005. Allocation for security spending has been maintained at 3.2% of GDP in FY2006 compared with the revised estimate of 3.3% of GDP in FY2005. However, budgetary allocations for economic and social sectors were under spent in the last two fiscal years whereas security expenditure exceeded the budget allocation.

F. Monetary Developments and Inflation

29. The liquidity position of commercial banks tightened during the first nine months of FY2005, reflecting the slower growth of remittances and increase in consumer loans[5] (Table 1.3). While growth in industrial loans remained sluggish, banks increased consumer loans through attractive packages and aggressive marketing. However, growth of foreign assets slowed to 7.8% from 15.1% last year due to the decline in foreign loans. This caused broad money growth to slow to 6.2% from 9.1% last year.

30. Despite the squeeze in the liquidity position, there was no upward movement in commercial bank deposit rates, which remain well below the inflation rate. The intermediation spread of commercial banks also remained largely unchanged, as lending rates remained constant. The liquidity squeeze, however, contributed to increasing the T-bill rates further during FY2005. Ninty-one day T-bill rates increased to 3.1% in April 2005 from 0.6% in August 2004[6], still below the inflation rate of about 4.5%.

31. NRB absorbed more than NRs15.8 billion worth of commercial bank liquidity and injected over NRs7.1 billion of liquidity during the first nine months of FY2005 – resulting in a net withdrawal of liquidity amounting to NRs8.7 billion. NRB interventions were carried out through open market sale, purchase, repo, and reverse repo auctions. A Liquidity Monitoring Framework (LMF) introduced by NRB from FY2005 guided the amount and timing of its interventions.

32. Government domestic debt securities

Table 1.3: Balance of Payments Summary
(US$ Million)

Items	First Nine Months		% of GDP		
	FY2004	FY2005	FY2004	FY2005	% change
Current Account	220.6	319.2	3.3	4.4	44.7
Trade Balance	-715.6	-654.6	-10.7	-9.0	-8.5
Good: exports f.o.b	564.8	587.6	8.4	8.1	4.0
Good: imports f.o.b	-1280.4	-1242.3	-19.1	-17.1	-3.0
Net Services	95.7	16.6	1.4	0.2	-82.6
Tourism	166.9	114.3	2.5	1.6	-31.5
Net Current Transfer	862.6	972.8	12.9	13.4	12.8
Workers' remittances	704.7	792.6	10.5	10.9	12.5
Capital Account Balance	16.7	11.2	0.2	0.2	-32.8
Financial Account	-140.2	-345.9	-2.1	-4.8	146.7
Balance of Payments	-166.8	-67.5	-2.5	-0.9	-59.5

Source: Nepal Rastra Bank

[5] Commercial bank deposits grew 3.2% during the first nine months of FY2005 compared with 8.9% during the first nine months of FY2004. Financial sector claims on the private sector grew 13.2% during the first nine months of FY2005 and 15.8% year on year on account of a sharp increase in consumer loans. As a result, the liquidity of commercial banks fell sharply by 20% during the first three quarters of FY2005.

[6] 91 day T-bill rates increased further to 3.9% in July 2005.

have been issued and serviced since 1962. The major instruments for domestic debt financing have been T–bills with less than one-year maturity and other debt instruments such as development bonds, special bonds, and savings certificates with maturity over one year to five years. Since fiscal year FY1995, the NRB has also operated a secondary market for T-bills and its own bonds, NRB Bonds, within which banks and financial institutions are licensed to function as market makers to provide an active secondary market for investors.

33. Important changes in the domestic debt securities market initiated by the NRB over the last several years include the announcement of calendar for government debt securities, the issuance of 28 and 182-day T-bills, the construction of a benchmark yield curve, and the sale of NRB-held government securities through auction on the secondary market. However, Nepal's domestic debt market is still in the early stages of development and policy reforms are needed for its further development (Box 1.2).

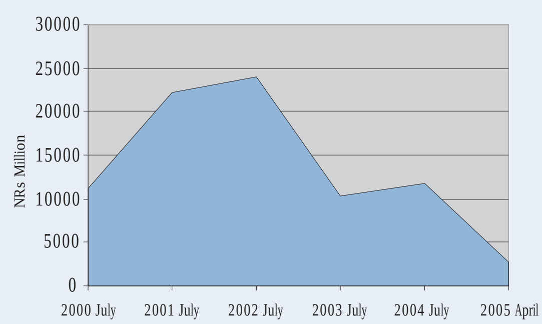
34. Inflationary pressures have picked up following the upward adjustments in petroleum prices and VAT rate, low paddy production, import controls on sugar in late 2004, and the hike civil servant allowances. Consumer Price Index (CPI) inflation, on a point-to-point basis, accelerated to 5.8% in April 2005 from 2.4% in August 2004. Inflation was the highest in the hills (6.5%), reflecting increased transport costs, pushed up by oil prices and security concerns. However, average CPI inflation remained moderate at 3.9% during the first nine months of FY2005 compared with 4.7% during the same period in FY2004. Average CPI inflation is expected to rise to about 4.5% for the year as a whole, as the increase in petroleum prices and VAT rate take full effect.

35. In response to the acceleration of inflation and the rising interest rate differential with India, NRB announced a cautious monetary policy for FY2006. The NRs peg with the IRs continues to be the strategic pillar of the monetary policy. Given the peg, inflation is targeted at about 5% for FY2006 in line with price developments in India. Facilitation of economic growth is the secondary objective of the policy. Broad money and narrow growth are projected to accelerate to 13.0% and 12%, respectively in FY2006 compared with 12% and 11.2% in FY2005. Domestic credit is projected to expand 15.4% in FY2006 compared with 14.2% in FY2005.

36. As a part of its cautious policy, NRB has hiked up the bank rate to 6.0% from 5.5%, and the refinance rate for export credit and agricultural credit from 3.0% to 3.5% in FY2006. The cash reserve ratio (CRR) and the refinance rate for sick industries have been left unchanged at 5.0% and 1.5%, respectively. NRB's monetary policy for FY2006 is a departure from the accommodative monetary policy of the last few years when CRR, bank rates and refinance rates were lowered. However, the monetary easing helped little in boosting economic growth, which continued to be weighed down by sluggish investments. Lending rates largely remained unchanged. Domestic credit picked up but mostly due to growth in consumer loans. Growth in industrial credit, critical for economic recovery, remained sluggish. This year, NRB has signaled its commitment to counteract the rising inflation while at the same time avoiding a significant tightening of the monetary stance, which could adversely affect economic growth.

37. Nepal's foreign exchange reserves increased 2.8% in the first nine months of FY2005 to $1.5 billion. This is equivalent to eight months of imports of goods and services. Convertible currency reserves increased 11.2% to $1.45 billion while non-convertible reserves – mainly IRs – declined sharply by 76% to $37 million (Figure 1.3). Non-convertible

Figure 1.3 - Indian Currency Reserves, FY2000-FY2005



Source: Nepal Rastra Bank

Box 1.2 - Developing the Government Bond Market in Nepal

Public debt is one of the most important sources of financing for the government. Given the increasing difficulty Nepal will face in obtaining concessional foreign loans as it develops, efforts should be made to improve the efficiency of public debt management by developing domestic financing tools. The development of a domestic capital market will contribute to minimizing long-term costs of debt under implied cost and risk trade-off and also provide safe assets and benchmarks for the pricing of other securities. The creation of an efficient and liquid bond market is a gradual process and requires a long-term government commitment. Given the characteristics of the Nepal's domestic debt market, the following policy reforms are required for its further development:

Consolidation of Long-term Bonds. The product structure of government bonds in Nepal is unnecessarily scattered. As these bonds no longer have any difference in tax benefits, there is no clear rationale for this. The consolidation of development bonds, special bonds, and savings certificates into a single series of long term government bonds will help improve liquidity and contribute to building an efficient bond market in Nepal. Towards this, the NRB is already planning to issue only T-bills, development bonds, and citizens saving bonds from FY2006.

Introduction of Longer-term Benchmarks. At present, T-bills with maturity of less than one year account for more than 70% of total public domestic debt. To minimize the borrowing costs with a prudent degree of risk, however, it is necessary to simplify the maturity structure of T–bills and increase the proportion of longer-term financing. According to a study on the optimal maturity structure under the Cost at Risk (CaR) minimization framework, the optimal benchmarks for Nepal turn out to be a combination of government bonds with six months, one year, three years, and five years maturities in the proportions of 30%, 30%, 30%, and 10%, respectively.

Introduction of a Reopening System. A reopening (or fungible issue) system should be introduced to improve the liquidity of government bonds. This will help reduce issuance costs and enhance liquidity in the secondary market. Debt management techniques such as buybacks, bond exchanges, reverse auctions, and repo transactions should be developed to spread out concentrated redemptions.

Development of the Futures and Repo markets in the long run. Liquidity on the secondary market cannot be disassociated from the creation, development and promotion of the futures and repo market. In particular, the existence of the efficient futures and repo markets are essential for risk management of primary dealers and for the successful introduction of a primary dealer system. Therefore, in the medium to long run, the development of futures market and repo markets should be encouraged simultaneously with the government's effort in building an efficient primary market to enhance the liquidity of the secondary market.

Improving Infrastructures for the Government Bond Market. To begin with, paper bonds must be replaced with a book entry system. Then, to maximize the benefits of the book entry system, it will be important to build a central security depository (CSD). The CSD is a computer-based data recording system, which records ownership by type of securities, date of purchase, date of maturity and value. The FY2006 monetary policy has pledged to adopt a book entry system while the installation of CSD is in pipeline as part of a government project to strengthen the Nepal Stock Exchange (NEPSE).

Introduction of a Centralized Trading Platform. The government is planning to enlist the government debt securities on the NEPSE and allow non-banking financial institutions to participate in the secondary market transactions. In the process of enlisting the government debt securities in the NEPSE and placing buy and sell orders through a centralized trading platform, the introduction of an electronic exchange trading system should be given a serious consideration.

reserves have declined despite a 21% growth in exports to India. While a part of the decline in non-convertible reserves is explained by the increase in imports of petroleum products and decline in tourist arrivals from India, the sharpness of the decline suggests some speculative outflow of capital to India. Nepal's currency peg with India might come under pressure if the outflow continues unabated.

G. Balance of Payments

38. Exports expanded 4.0% year on year in US-dollar terms in the first nine months of FY2005 – half the rate achieved in the same period in FY2004 (Table 1.3). Despite a marginal recovery in the export of carpets, exports to third countries[7] were down 18.9% from the same period last year. Readymade garment exports were 37.1% lower during the first nine months of FY2005 with almost a 50% decline in the mid-December 2004 to mid-April 2005 period, after the MFA quotas expired (Figure 1.4). Similarly, exports of handicraft and pashmina goods declined by 19.4% and 5.6%, respectively. While it was expected that garment exports would be affected by the expiration of the MFA, other major exports to third countries have also declined during the first nine months of FY2005.

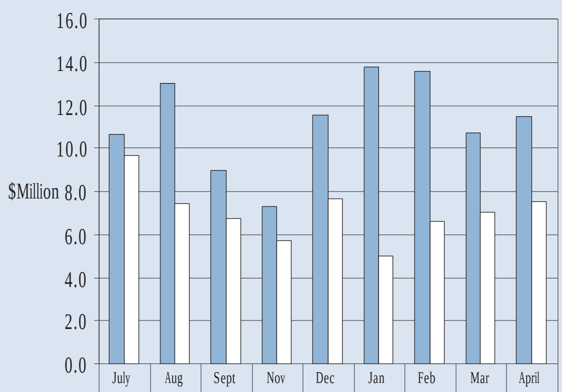
39. Unlike Nepal, other South Asian countries with major garment industries are adapting to the aftermath of the MFA expiration reasonably well. Garment exports of Bangladesh and Sri-Lanka have grown by about 20% in the six months since the MFA expired while Nepal's exports have fallen sharply. This suggests that Nepal could have surmounted the challenges of quota loss if it had made adequate preparations to improve competitiveness like it's South Asian neighbors. For instance, a special economic zone near the Indian border or negotiation of duty free access to the US market could have helped limit the adverse effects of MFA expiration. However, efforts on this front were stymied by political instability even as conflict-related disruptions continued to undermine the competitiveness of the garment industry.

40. The slowdown in overall export growth masked a robust increase in exports to India, which grew 21.2% during the first nine months of FY2005 compared with 12.4% in first nine months of FY2004. Exports to India were buoyed by the resumption of vegetable ghee exports and increase in exports of agricultural products. The increase in exports to India is part of a larger structural shift of Nepal's exports from third country markets to the Indian market. The shift started with the signing of the free trade agreement with India in 1996. Since then, the share of Nepal's exports to India in overall exports has increased from less than 20% to over 50%.

41. Exports have declined on an average by 3.8% since FY2001 compared with an average growth of 14.2% in the previous decade. This is largely a result of conflict related disruptions and external shocks such as the one arising from the expiration of the MFA. However, Nepal has several things going in its favor over the medium term – comparative advantage in number of agriculture and manufacturing niche markets, two large rapidly growing neighbors, the availability of preferential access to Europe, India and Canada, and hydroelectric resources. Nepal will have to pursue reforms to improve trade policy and the investment climate to take advantage of these assets.

42. Imports declined 3.0% year on year in the first nine months of FY2005, reflecting weak domestic demand and the impact of strikes

Figure 1.4 - Monthly Ready Made Garment Exports



	July	Aug	Sept	Nov	Dec	Jan	Feb	Mar	April
FY2004	10.6	13.0	9.0	7.3	11.5	13.7	13.	10.7	11.5
FY2005	9.7	7.5	6.8	5.7	7.7	5.0	6.	7.0	7.5

Months

Source: Nepal Rastra Bank

[7] Countries other than India.

and blockades on trade. Excluding imports of petroleum products, which grew 30%, the decline in imports was 10.5%. Import of industrial raw materials, construction materials, textiles and apparels, and transport and communication equipment declined most sharply.

43. Tourism receipts declined by 31.5% in the first nine months of FY2005 reflecting a 12% drop in tourist arrivals. Nepal's tourism has suffered from conflict induced negative publicity in the international markets. Tourist arrivals began dipping in September 2004, just before the peak tourist season, when riots broke out in Kathmandu. The downturn has continued since then with even sharper declines reported in February, March and April 2005. Of particular concern has been the decline in Indian tourist arrivals, which are usually robust during the summer season.

44. Worker remittances increased 12.5% in the first nine months of FY2005 compared with 10.5% in the same period in FY2004. But much of the increase was on account of an upward adjustment in the pensions rates of retired British soldiers. Excluding pension, remittances grew only 2.6% compared with 4.0% in the first nine months of FY2004, reflecting the impact of the 1 September 2004 riots and Malaysia's decision to temporarily halt the intake of Nepal's workers after the December 2004 Tsunami. The sluggish growth in remittance earning from India suggests that Nepal's workers may also be increasingly investing in higher yielding overseas assets given the low rates of return offered by Nepal's banks. The political and economic uncertainties in Nepal may also be deterring workers from remitting to Nepal.

45. The decline in imports compressed the trade deficit to 8.5% of GDP in the nine months of FY2005 compared with 9.0% of GDP in the same period in FY2004. A narrower trade deficit caused the current account surplus to widen to 4.4% of GDP from 3.3% in FY2004. A persistent current account surplus is a sign of weakness for a country at Nepal's stage of development, as it implies that Nepal is not drawing in sufficient external capital needed to finance its development.

46. The East Asian countries and China are able to invest over 40% of GDP by running current account deficits. Nepal's persistent current account surplus, on the other hand, means that Nepal is saving more than investing – something that usually happens only in developed countries. The current account surplus also means Nepal is acquiring foreign assets – building up international reserves. Nepal at its present stage of development should consider running a current account deficit within limits to fund its development. These borrowings invested productively would support economic growth, which in turn would maintain debt-service at a manageable level.

Table A1.1: Country Economic Indicators

Item	2001	2002	2003	2004[a]	2005[b]
			Fiscal Year		
A. Income and Growth					
1. GDP per Capita ($ current)	241	233	242	271	289
2. GDP Growth (% in constant prices)	4.8	(0.4)	2.9	3.3	2.0
Agriculture	5.5	2.2	2.5	3.9	2.8
Industry	3.2	2.9	3.0	1.0	0.7
Services	5.3	(1.4)	3.3	4.3	2.1
			(% of GDP)		
B. Saving and Investment (current and market prices)					
1. Gross Fixed Capital Formation	19.0	19.3	19.1	19.2	19.3
2. Gross National Saving	18.9	16.4	15.2	14.8	14.2
			(annual % change)		
C. Money and Inflation					
1. Consumer Price Index[c]	2.4	2.9	4.8	4.0	4.5
2. Total Liquidity (M2)	15.2	4.4	9.8	12.8	6.6
			(% of GDP)		
D. Government Finance					
1. Revenue and Grants	13.0	13.1	14.5	14.6	15.4
2. Expenditure and Onlending	17.6	17.0	16.0	16.1	16.5
3. Overall Fiscal Surplus (deficit)	(4.5)	(3.9)	(1.5)	(1.5)	(1.1)
E. Balance of Payments					
1. Merchandise Trade Balance (% of GDP)	(13.7)	(12.6)	(15.4)	(15.7)	(12.7)
2. Current Account Balance (% of GDP)	4.9	4.3	2.5	2.9	3.5
3. Merchandise Export ($) Growth (annual % change)	11.7	(20.3)	(13.8)	14.9	7.8
4. Merchandise Import ($) Growth (annual % change)	6.7	(15.3)	7.1	16.0	(3.8)
F. External Payments Indicators					
1. Gross Official Reserves (including gold, $ million)	1,009.3	1,030.6	1,158.8	1,446.5	1515.9
Months of current year's imports of goods and services	6.9	7.4	7.9	8.2	8.2
2. External Debt Service (% of exports of goods and services)	6.8	8.5	10.3	10.3	9.4
3. Total External Debt (% of GDP)	47.1	50.8	48.8	47.0	44.0
G. Memorandum Items					
1. GDP (current prices, NRs billion)	410.8	422.3	454.9	494.9	592.0
2. Exchange Rate (NRs/$, average)	73.7	76.7	77.9	73.8	72.3
3. Population (million)	23.2	23.7	24.2	24.8	25.3

GDP = gross domestic product, NRs= Nepalese rupees.
[a] Revised estimates
[b] Prelimenarly estimate & staff estimates.
[c] Annual percentage change (period average)

Sources: Ministry of Finance. 2004 Economic Survey. Kathmandu; Central Bureau of Statistics. 2004. National Accounts of Nepal. Kathmandu; and additional information provided to Asian Development Bank staff.

Table A1.2: Country Poverty and Social Indicators

Item	1985		1990		Latest Year	
	Period					
A. Population Indicators						
1. Total Population (million)	16.2		17.9		24.8	(2004)[a]
2. Annual Population Growth Rate (% change)	2.1		2.1		2.3	(1991-2001)
B. Social Indicators						
1. Total Fertility Rate (births/woman)	5.9		5.3		4.3	(2004)
2. Maternal Mortality Rate (per 100,000 live births)	—		850	(1991)	540	(2002)
3. Infant Mortality Rate (below 1/1,000 live births	115.4		102.1		66.0	(2002)
4. Life Expectancy at Birth (years)	50.9		53.6		59.6	(2002)
Female	50.0		52.9		59.4	(2002)
Male	51.6		54.2		59.9	(2002)
5. Adult Literacy (%)	26.5		30.5		42.9	(2004)
Female	9.8		14.0		26.4	(2004)
Male	42.7		47.5		61.6	(2004)
6. Primary School Gross Enrollment (%)	-		61.0		80.4	(2004)
7. Secondary School Gross Enrollment (%)	25.2		33.1		50.5	(1997-2000)
8. Child Malnutrition (% below age 5)	69.1	(1975)	57.0	(1990)	48.0	(1995-2002)
9. Population Below Poverty Line (international, %)[b]	—		—		37.7	(1995)
10. Population with Access to Improved Water Sources (%)	—		66		72	(2001)
11. Population with Access to Improved Sanitation Facilities (%)	—		21		28	(2000)
12. Public Education Expenditure (% of GDP)	2.7		2.0		2.9	(2004)
13. Human Development Index	0.42		0.42	(1990)	0.50	(2002)
Rank/Total Number of Countries	114/130	(1987)	152/173	(1990)	140/177	(2002)
14. Gender-Related Development Index	—		0.33	(1995)	0.48	(2001)
Rank/Total Number of Countries	—		148/163	(1995)	116/177	(2001)
C. Poverty Indicators						
1. Poverty Incidence	—		42	(1996)	30.8	(2004)
2. Percent of Poor to Total Population	—		42	(1996)	30.8	(2004)
Urban	—		23	(1996)	9.6	(2004)
Rural	—		44	(1996)	34.6	(2004)
Mountain	—		56	(1996)	32.6	(2004)
Hills	—		41	(1996)	34.6	(2004)
Terai	—		42	(1996)	27.6	(2004)
3. Poverty Gap	—		11.75	(1996)	7.55	(2004)
4. Poverty Severity Index	—		4.67	(1996)	2.7	(2004)
5. Inequality (Theil L Index)	—		—		—	
6. Human Poverty Index	—		—		41.9	(2001)
Rank	—		—		70	(2001)

— = not available; GDP=gross domestic product.

[a] Staff estimate.
[b] $1 a day at 1985 international prices, adjusted for purchasing power parity.

Sources: United Nations Development Programme. 1993, 1998, 2003, and 2004. Human Development Report. New York; Ministry of Finance. 2004. Economic Survey. Kathmandu; Nepal South Asia Centre. 1998. Nepal; Human Development Report. Kathmandu; Central Bureau of Statistics. 1996. Nepal Living Standards Survey Report. Kathmandu; World Bank. 2004. World Development Indicators. Washington D.C; HMG Nepal/United Nation Country Team. 2002. Millenium Development Goals – Progress Report. 2002.